

Policy Contribution  
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# High public debt in euro-area countries: comparing Belgium and Italy

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## Executive summary

**DURING THE 1970s** and 1980s, Belgium and Italy accumulated huge amounts of public debt. In the early 1990s, at the time of the Maastricht Treaty, public debt reached a peak of nearly 140 percent of GDP in Belgium and nearly 130 percent in Italy. After Maastricht, both countries made major fiscal efforts in order to qualify for membership of the euro.

**WHEN THE EURO** was launched in 1999, public debt had been brought down substantially in the two countries, to roughly 110 percent of GDP. At the time Belgium and Italy were also identical in another respect: GDP per capita.

**TODAY THE SITUATION** is very different. The level of public debt is 130 percent of GDP in Italy against only 100 percent in Belgium. Worse, in GDP per capita terms, Italy is now 20 percent poorer than Belgium. No wonder Italians are dissatisfied with their lot.

**THIS POLICY CONTRIBUTION** looks at the evolution of public debt in Belgium and Italy since 1990 and seeks to explain the contrasting evolution in the two countries in the run-up to the introduction of the euro, during the early years of the euro and since the beginning of the crisis.

**IT FINDS THAT**, after substantial fiscal efforts during a relatively brief period before the launch of the euro, Italy's efforts tailed off, while Belgium continued to consolidate its debt at an impressive pace. Italy also did too little to improve its growth performance, which lagged significantly behind Belgium's and that of all other euro-area countries.

**WHEN THE CRISIS** hit the two countries, Italy was therefore much more vulnerable to market sentiment than Belgium, especially when the sovereign debt crisis spread from Greece to other euro-area countries. Italy responded to the onslaught of markets with austerity measures, which made matters worse, sending GDP growth into negative territory and increasing the debt-to-GDP ratio.

**POLITICS HAS BEEN** central to the contrasting debt dynamics in the two countries. Bad domestic politics prior to Maastricht were responsible for the huge accumulation of public debt in Belgium and Italy up to the early 1990s. Maastricht brought fiscal discipline to both countries, but the constraint proved more binding on Belgium than on Italy once the two countries joined the euro. During the crisis, Belgium fared better than Italy because its political class displayed an absolute commitment to debt sustainability and to euro membership that was at times lacking in Italy.



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# 1 Introduction

In 1999, when they joined the euro, Belgium and Italy were almost identical in two respects. Both had public debts equal to about 110 percent of their respective GDPs – far in excess of the 60 percent Maastricht requirement for membership of the euro – and their levels of GDP per capita (measured at purchasing power parities, PPP) were almost identical.

Today the situation is very different. In 2017, the level of public debt was just above 100 percent of GDP in Belgium and more than 130 percent in Italy. The gap between the two countries is even more dramatic as far as GDP per capita is concerned. In 2017, the level in Italy (measured at PPP and in constant prices) was basically the same as in 1999, implying that the country has been through two lost decades. By contrast, Belgium is nearly 20 percent richer than it was in 1999, and thus 20 percent richer per capita than Italy in 2017. No wonder Italians are so upset about the state of their economy.

This Policy Contribution looks at the evolution of public debt in Belgium and Italy since 1990 and uses the debt dynamics equation to explain the contrasting evolution in the two countries in the run-up to the introduction of the euro, during the early years of the euro and since the beginning of the crisis. It argues that Italy's current predicament was not caused by the euro as some have suggested. Instead, as the experience of Belgium suggests, the euro could have been used also by Italy to undertake sufficiently large fiscal adjustment prior to the crisis to avoid the harsh adjustment the crisis eventually imposed on the country.

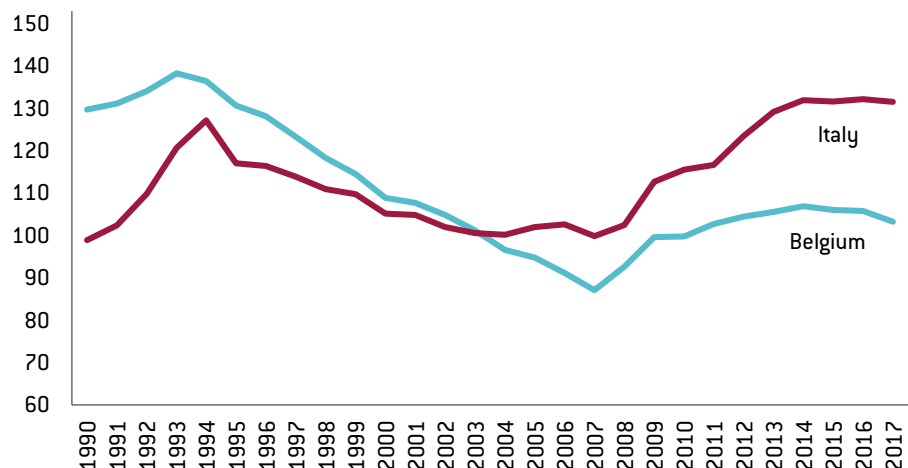
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## 2 The evolution of the debt-to-GDP ratio

Figure 1 shows the evolution of the debt-to-GDP ratio for the two countries from 1990 to 2017. At the beginning of the period, both countries already had high public debt ratios, but at the time it was in Belgium that it stood at around 130 percent, while in Italy it was roughly 100.

**Figure 1: Debt-to-GDP ratio (in %), 1990-2017**



Source: Bruegel based on IMF WEO database.

These high public debt levels owed a lot to political instability in the two countries during the previous two decades. Between 1970 and 1990, Italy had 24 governments, each lasting on average only ten months, a record among advanced countries. Belgium had 16, each government lasting on average one year and four months. During this period, the debt ratio increased by nearly 80 percentage points in Belgium and 60 in Italy, the biggest jumps among

advanced countries during these two decades according to the International Monetary Fund's Historical Public Debt Database<sup>1</sup>.

The debt-to-GDP ratios in the two countries peaked soon after the signature of the Maastricht Treaty in 1992. This reflected the political commitment of both countries to meet the treaty's debt requirement for euro adoption: a debt-to-GDP ratio not exceeding 60 percent, or *"sufficiently diminishing and approaching the [60 percent] reference value at a satisfactory pace"*.

In Belgium the debt ratio diminished rapidly after peaking at 138 percent in 1993, reaching 118 percent in 1998. It continued to decrease after the introduction of the euro, reaching 87 percent in 2007. In Italy the decline was also significant but less spectacular than in Belgium. After peaking at 127 percent in 1994, the debt ratio declined to 111 percent in 1998 and reached around 100 percent in 2002, a level at which it roughly remained until 2007.

The crisis reversed this downward trend in both countries. The debt-to-GDP ratio increased steadily between 2007 and 2014, by 20 points in Belgium and 30 points in Italy, reaching new peaks of 107 percent in Belgium and 132 percent in Italy.

Hence, there are significant similarities in the evolution of the two countries' debt-to-GDP ratios: a high level in the early 1990s, peaking immediately after the signature of the Maastricht Treaty; a steady decline thereafter and until roughly 2007; and a major reversal starting in 2008 and ending in 2014. There are also two important differences: after Maastricht and before the crisis, and although starting from a higher debt level than Italy, Belgium succeeded in decreasing its debt ratio to a lower level than Italy's; and during the crisis, Belgium managed to increase its debt ratio less than Italy.

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## 3 The debt dynamics equation

In order to understand the contrasting evolutions in the two countries, we recall the debt dynamics equation:

$$\Delta b = d + (r-g)b$$

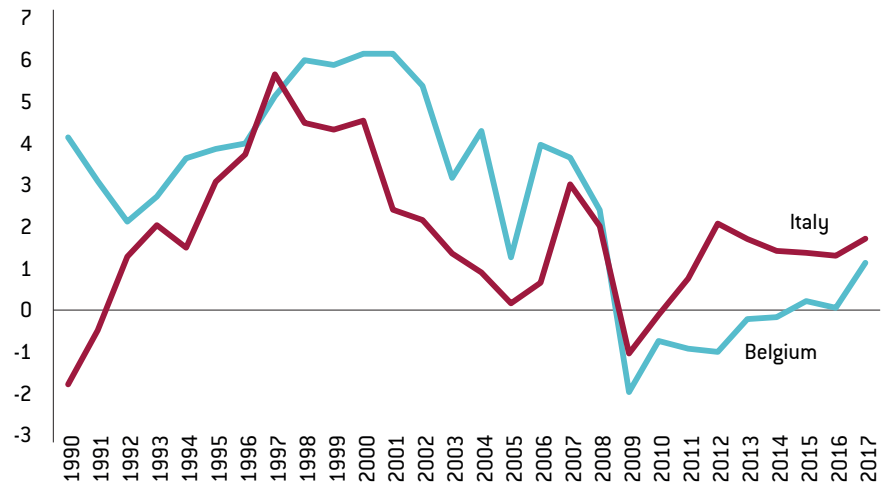
where  $b$  is the ratio of debt to GDP,  $\Delta b$  is the increase of this ratio,  $d$  is the ratio of the primary deficit (public spending excluding interest payments on the public debt, minus public revenue) to GDP,  $r$  is the real interest rate on government debt and  $g$  is the growth rate of real GDP.

This equation states that the debt-to-GDP ratio is bound to increase if the government runs a primary deficit and if the interest rate on the debt is higher than the growth rate of GDP. If  $(r-g)$  is close to zero, ie if the interest rate and the growth rate of the economy are roughly equal, then the evolution of the debt is entirely driven by the primary balance: the debt increases if there is a primary deficit and it decreases if there is a primary surplus. If  $(r-g)$  is positive and large then the debt might become explosive unless the primary balance is positive and sufficiently large. If  $(r-g)$  is negative then the debt will tend to stabilise at some level.

Figures 2 through 6 show the different elements on the right-hand side of the debt dynamics equation for Belgium and Italy. Figure 2 shows the evolution of the primary surplus/deficit; Figure 3 shows the evolution of  $(r-g)$ ; Figures 4 and 6 show the evolution of, respectively, the real interest rate on the public debt ( $r$ ) and the real growth rate ( $g$ ); and Figure 5 shows the evolution of 10-year government bond yields, a major determinant of the nominal interest rate on the public debt.

<sup>1</sup> Maes and Quaglia (2003) discuss how fragmented political party systems, coalition governments and government instability contributed to chronic budget deficits in both countries during the 1970s and 1980s.

**Figure 2: Primary surplus (+)/deficit (-) as a ratio of GDP (in %), 1990-2017**



Source: Bruegel based on IMF WEO database.

**Figure 3:  $(r-g)$  (in %), 1996-2017**



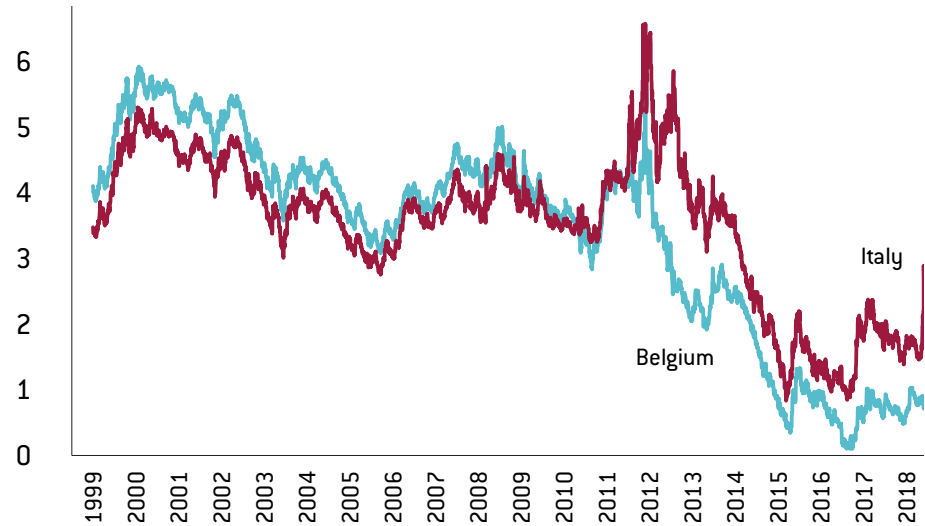
Source: Bruegel (see Figures 4 and 6).

**Figure 4: Implicit real interest rates on government debt (in %), 1996-2017**

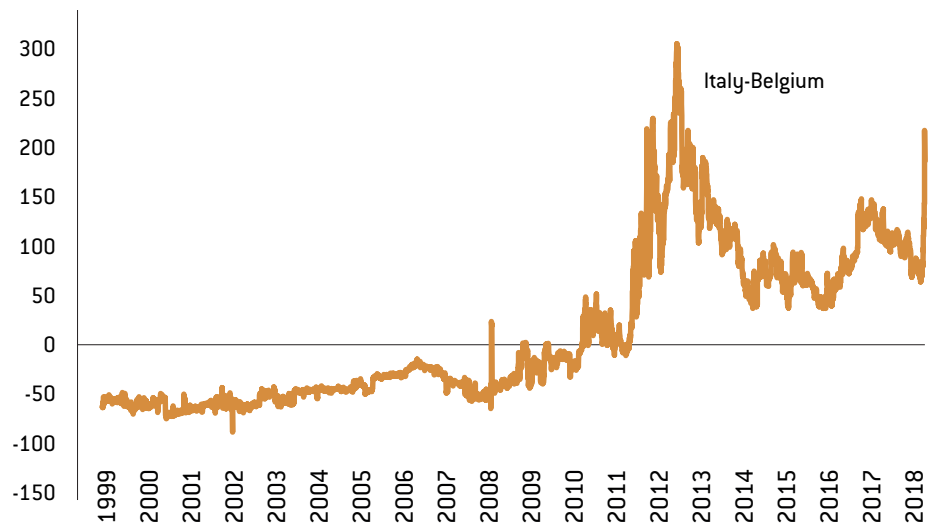


Source: Bruegel based on AMECO database, European Commission.

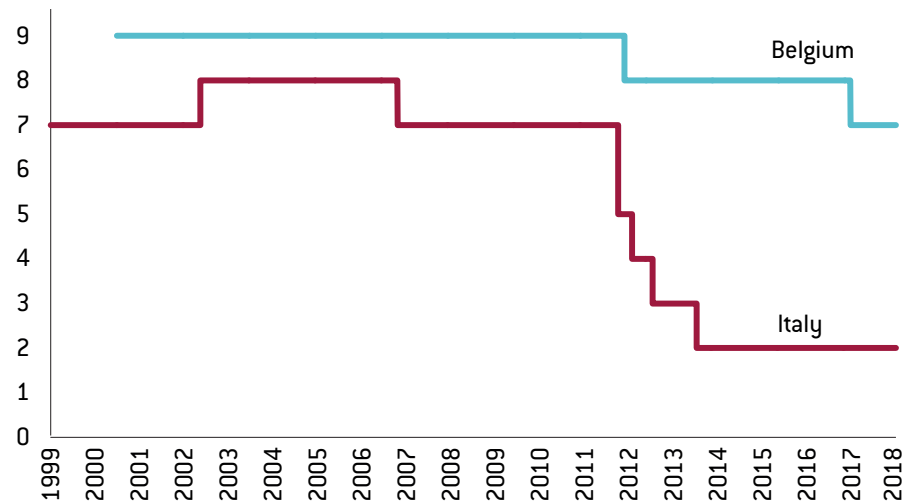
**Figure 5A: 10-year yields on government bonds (%), 1/1/1999-31/5/2018**



**Figure 5B: Spread between Italian and Belgian 10-year government bonds (basis points)**

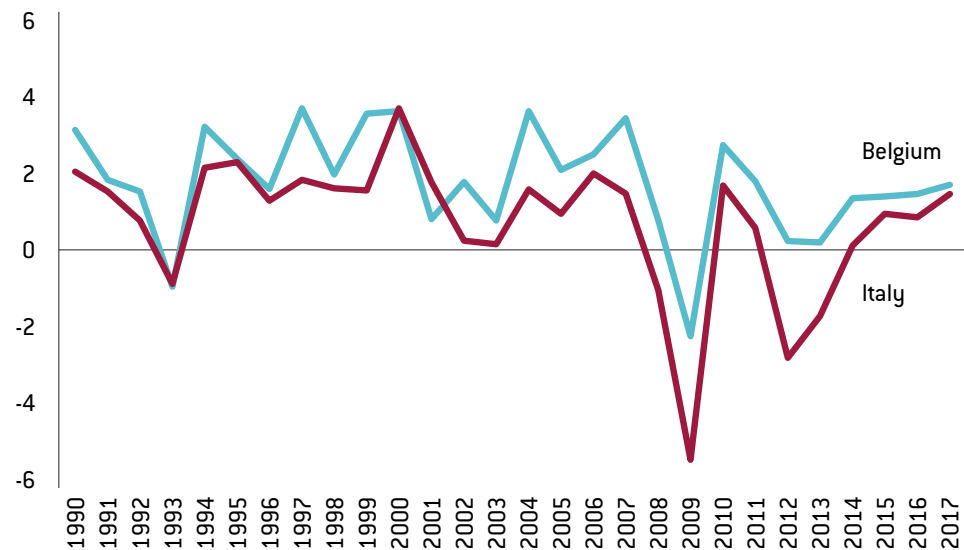


**Figure 5C: Sovereign ratings, 1999-2017**



Source: Bruegel. Note. Averages of Fitch, S&P and Moody's ratings. 10=AAA/Aaa; 9=AA+/Aa1; 8=AA/Aa2; 7=AA-/Aa3; 6=A+/A1; 5=A/A2; 4=A-/A3; 3=BBB+/Baa1; 2=BBB/Baa2; 1=BBB-/Baa3; 0=BB+/Ba1

**Figure 6: Real GDP growth rate (in %), 1990-2017**



Source: Bruegel based on IMF WEO database.

## 4 Explaining debt dynamics in the two countries: from the early 1990s to 2007

In both countries the debt-to-GDP ratio reached a peak soon after the signature of the Maastricht Treaty, and subsequently declined more or less rapidly and more or less steadily until 2007.

In Belgium the debt ratio declined by 51 points of GDP between the peak (of 138 percent) in 1993 and 2007, an average of 3.7 points per year. By contrast, in Italy the debt ratio declined by only 27 points between the peak (of 127 percent) in 1994 and 2007, an average of only 2.1 points per year. Three factors explain the contrasting performances of the two countries.

The first factor is the government's primary balance. In Belgium, the government ran a primary surplus averaging 4.7 points of GDP per year from 1993 to 2007. The Italian government also succeeded in producing a primary surplus from 1994 to 2007, but it only averaged 2.9 points of GDP per year (Figure 2).

The second factor is the growth rate of GDP, which averaged 2.4 percent per year in Belgium from 1993 to 2007, but only 1.7 percent in Italy from 1994 to 2007. Much has been written about the relatively poor growth performance of the Italian economy during this period (see, for instance, Faini and Sapir, 2005). It is sufficient to say here that after a remarkable growth and convergence performance, Italy (or at least a significant part of it) seems to have been unable to modernise in response to the economic and social challenges of globalisation and technological change that accelerated during the 1990s.

In particular, total factor productivity (TFP) growth has stagnated or even decreased since the mid-1990s. According to Calligaris *et al* (2016), a large fraction of the Italian productivity slowdown during the past 20 years arises from increased misallocation of resources, with the country being increasingly unable to reallocate resources from low- to high-productivity firms. The authors estimate that if misallocation had remained at its 1995 level, aggregate TFP in 2013 would have been 18 percent higher than it was actually was,

which would have translated into 1 percent higher GDP growth per year between 1995 and 2013.

The third factor is the real interest rate on government debt, which declined substantially in both countries in the run-up to and early days of the euro. In contrast to the previous two factors, on which Belgium performed better than Italy, here Italy did better than Belgium. On average during this period<sup>2</sup>, the real interest rate paid on government debt was only 3.7 percent in Italy compared to 4.3 percent in Belgium. This difference reflected two factors: the lower yields on Italian debt than on Belgian debt because of the bigger size of the Italian government bond market, and the higher inflation rate in Italy compared to Belgium.

Clearly, with rapidly declining interest rates on government debt, and lower levels than in Belgium, Italy missed an easy opportunity to reduce more substantially its public debt ratio between the early 1990s and 2007. Successive Italian governments should have taken more vigorous action to reduce the debt ratio. Two avenues should have been pursued more forcefully.

First, Italy should have implemented more structural reforms to increase the growth rate of the economy. But raising the average annual growth rate by say 0.5 percent, while useful, would not have made a very substantial difference to the debt ratio.

Second, would have been to run primary surpluses of 4 or more points of GDP during the entire period, as Belgium did. For Italy, this would have made a substantial difference. In fact, the Italian government succeeded in running an average primary surplus of 4.5 points of GDP between 1996 and 2000, the five-year period just before and after the launch of the euro, a period during which the primary surplus of Belgium averaged 5.4 points of GDP. Unfortunately during the next 7 years, between 2001 and 2007, the Italy's average primary surplus fell to barely 1.5 points of GDP. While some adjustment fatigue could have been expected, Italy could have made more fiscal effort than it did. In Belgium, the primary surplus also fell after 2000, but it still averaged 4 points of GDP between 2001 and 2007.

There were two immediate consequences of Italy's inability to boost GDP growth and to run larger primary surpluses. The first was for the sustainability of the public debt.

Despite having a lower debt ratio than Belgium at the time, Italy entered the euro in January 1999 with a lower sovereign rating than Belgium (Figure 5C). There were two reasons for this disadvantage for Italy: greater political instability and a lower primary surplus in the run-up to the euro. In May-June 2002, one year into the second Berlusconi government, Moody's and Fitch both increased their Italy ratings by one notch, bringing them just one notch below Belgium's. However, in July 2004, S&P downgraded Italy by one notch and in October 2006, five months into the second Prodi government, it further lowered its rating, while Fitch also lowered its rating, in both cases by one notch.

To justify their downgrading of Italy in October 2006, a few days after the adoption by the parliament of the budget, S&P and Fitch cited what they judged a disappointing budget to redress the situation of low growth and rising debt inherited by the Prodi government from the Berlusconi government.

The second consequence of Italy's inability to boost GDP growth was felt in terms of living standards. Between 1990 and 1996 GDP per capita (measured at PPP and in constant prices) was 1 or 2 percent higher in Italy than in Belgium. By 2007 it was 9 percent higher in Belgium than in Italy.

2 The figures in this paragraph are not fully comparable to those in the previous two paragraphs because the European Commission's AMECO database only provides data on the implicit interest rates on government debt starting in 1996.

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## 5 Explaining debt dynamics in the two countries: from 2007 till 2018

In 2007, on the eve of the crisis, Belgium and Italy still had high debt ratios – respectively 87 percent and 100 percent – but the underlying conditions in the two countries differed considerably in three respects. First, during the previous decade and a half Belgium had demonstrated a far greater political capacity than Italy to undertake fiscal adjustment. Second, during this period Belgian GDP grew considerably faster than Italy's. Third, at least in one aspect, the Belgian banking sector appeared to be far healthier than its Italian counterpart: non-performing loans (NPLs) as a share of total gross loans stood at 1.4 percent in Belgium, well below the euro-area average, while in Italy the ratio was 5.6 percent, by far the highest among euro-area countries. These three factors would play a major role during the crisis.

In 2008-09, the financial crisis hit the two countries, but affected them very differently. Belgian banks suffered significant losses mainly because of their high exposure to toxic assets originating in the United States, but the country's real economy resisted relatively well. Only in 2009, during the global recession, did growth in Belgium turn negative, with a GDP contraction of 2.3 percent, which resulted in a jump of bank NPLs from 1.4 percent in 2007 to 3.1 percent in 2009. The situation in Italy was exactly the opposite. Banks had almost no exposure to US toxic assets but the real economy was badly affected, with a GDP contraction of 1.1 percent in 2008 and of 5.5 percent in 2009, which led to an increase in NPLs from 5.6 percent in 2007 to 9.4 percent in 2009.

Although it unfolded differently in the two countries, the crisis produced similar effects on their debt-to-GDP ratios: an increase by 13 percentage points between 2007 and 2009 – from 87 percent to 100 percent in Belgium and from 100 percent to 113 percent in Italy.

The difference in the two countries' debt-to-GDP ratios remained broadly constant between 2007 and 2011, with a gap of roughly 13 percentage points in favour of Belgium. But by 2017 this gap had reached 28 percentage points. How did this happen?

As Figure 1 indicates, the increase in the debt-to-GDP differential between Belgium and Italy from 2011 to 2017 was entirely due to an increase in the Italian debt ratio (from 117 percent to 131 percent). By contrast the Belgian debt ratio remained basically constant (at 103 percent) during this period. What explains the divergence between Belgium and Italy during 2011-17 and the contrast between this period and the period 2007-11, when the two countries had the same evolution of their debt-to-GDP ratios?

The divergence between the two countries increased dramatically in 2011 and in 2012.

From the start of the euro in 1999 until early 2010, markets did not differentiate much between Belgian and Italian 10-year government bonds (Figure 5A). Owing to its bigger size and more liquid market, Italian debt enjoyed a slight advantage, with yields of roughly 50 basis points below Belgian issuance (Figure 5B). Although this premium in favour of Italian government paper gradually eroded in 2008 and 2009, it was not until May 2010, at the time of the Greek sovereign debt crisis, that markets started to demand higher yields on Italian debt than Belgian debt because of the fear that the Greek crisis would spread to other so-called Club Med countries such as Italy.

On 25 May 2010, the (fourth) Berlusconi government agreed a €25 billion austerity package for 2011 and 2012 to try and reassure markets that Italian public debt – the biggest in value terms among euro-area countries – was under control. The austerity measures were generally welcomed by markets though there was also concern that they would further depress private consumption and growth, hence making it more difficult for the country to avoid falling into a debt trap.

The *Financial Times's* Lex column (on 27 May) declared that *"another opportunity for structural reforms has been missed"* by the Italian government, an unfortunate situation *"because Italy's luck may be running out..."* [The] *eurozone crisis has transformed perceptions*



*of vulnerability to contagion from the eurozone debt crisis...One-off measures such as public spending cuts are all very well. But Italy's chronic underperformance needs a more transformational remedy."*

Between May and December 2010, the spread between Italian and Belgian 10-year government bonds stabilised at around 20 basis points in favour of Belgium. During the first five months of the following year, it even came down, averaging only 2 basis points. But starting in June 2011, Italy's spread with Belgium climbed rapidly, reaching more than 50 basis points in July, more than 100 points in August and more than 200 points in November (Figure 5B). The country was falling into the very debt trap it had been trying to avoid.

In summer 2011, under growing pressure from markets, the Italian government announced three fiscal consolidation packages in barely six weeks: on 30 June, in mid-July and in mid-August. However, none of these packages addressed the country's confidence crisis, which was rather blamed on *"a problem of bad politicians over and above a problem of bad policies"*<sup>3</sup>. The problem was that, just as it did in May 2010, the Italian government was repeatedly adopting austerity rather than growth-enhancing measures. Neither the prime minister nor his finance minister believed in growth-enhancing reforms: *"this is why they keep postponing and buying time – and in doing so, just making things worse. Their goal, it seems, is simply their own political survival regardless of the cost to Italy"* (Boeri, 2011).

The measures taken by the Italian government during the summer of 2011 were certainly not in line with the recommendations formulated in a letter of 5 August from Jean-Claude Trichet, the then European Central Bank president<sup>4</sup>, and Mario Draghi, then Bank of Italy governor, to Prime Minister Berlusconi. Contrary to the claim by Mody (2018) that its *"big focus was on more fiscal austerity"*, the letter in fact detailed a balanced package of measures calling for both *"significant measures to enhance potential growth"* and *"immediate and bold measures to ensuring the sustainability of public finances"* (Trichet and Draghi, 2011).

Unfortunately, as Boeri (2011) lamented, the Berlusconi government never implemented measures to enhance potential growth. The austerity-only measures adopted by Italy in 2010 and 2011 resulted in a significant growth divergence with Belgium. In 2009 and 2010 the two countries ran primary deficits to stimulate their weak economies, but Italy kept its primary deficit lower than Belgium, presumably because its sovereign rating was already two notches below Belgium's rating, meaning it needed to be more cautious. In 2011, Italy moved to a primary surplus of 0.8 percent of GDP, whereas Belgium continued to run a small primary deficit (Figure 2).

In September 2011, the situation in Italy took a turn for the worse. Since 2010 there had been regular discussions among market participants about the redenomination risk of Greece exiting the euro area. This risk was now spreading to other euro-area countries, including Italy. The first warning came on 13 September 2011 when Citi's Willem Buiter cautioned that *"[a]s soon as Greece has exited, we expect the markets will focus on the country or countries most likely to exit next from the euro area"*, naming Ireland, Italy, Portugal and Spain as *"the most obvious candidates"* (Cotterill, 2011).

Italy was now in serious trouble. It was not only in a debt trap but because of this it also faced a risk of redenomination. Market punishment was swift. On 19 September, blaming a dysfunctional Berlusconi government and weak growth performance, S&P downgraded its Italy credit rating by one notch to A. On 4 October, Moody's cut Italy's rating by three notches to A2, citing an increase in long-term funding risks for sovereigns in the euro area with high public debt levels and political uncertainty. And on 7 October, Fitch downgraded its rating of Italy by one notch to A+ for similar reasons.

On 9 November the spread between Italian and Belgian 10-year bonds broke the 200 basis point mark. By that time, Italy was in turmoil and Silvio Berlusconi, who was a defendant in several court cases and whose relationship with his finance minister had sharply deterio-

3 Boeri (2011) in a VoxEU column published at the time.

4 Jean-Claude Trichet is chair of the Bruegel board.

rated, was forced to cede his position of prime minister to Mario Monti a week later, on 16 November.

In order to stop a further rise in the yield of Italian debt, which reached more than 650 basis points in November 2011, and to avoid a further downgrade in the country's sovereign rating (which was further lowered by two notches by S&P and Fitch in January 2012 and by one notch by Moody's in February 2012), the new government took additional measures to increase the primary surplus, which jumped to 2.1 percent of GDP in 2012.

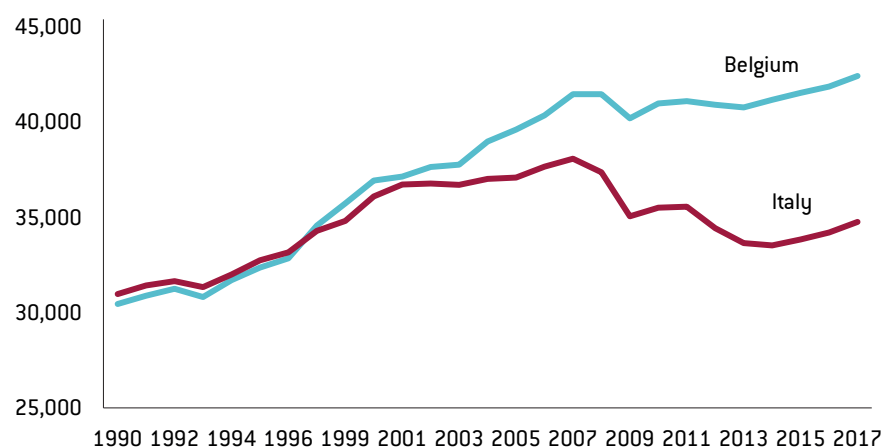
In the meantime, Belgium, which was run by a caretaker government from June 2010 to December 2011, continued to run a small primary deficit, which it could afford since its sovereign rating was only downgraded by one notch by S&P in November 2011, while Fitch even raised it by one notch in December 2011. Only Moody's downgraded its Belgium rating (by two notches) in December 2011, citing political uncertainty, though the timing was surprising since the political crisis ended that very month with the swearing-in of a new government.

In Italy, the result of the increased austerity measures was a collapse in GDP, which contracted by 2.8 percent in 2012, while it grew by a modest 0.2 percent in Belgium. The situation was repeated in 2013, when Italy again ran a relatively large primary surplus (of 1.7 percent of GDP) and its GDP further contracted by 1.7 percent, whereas Belgium continued to run a small primary deficit (of only 0.2 percent of GDP) and again managed to avoid a contraction of its GDP despite the unfavourable euro-area economic environment.

Alesina *et al* (2015) provide empirical evidence that fiscal austerity in Italy in 2011-13 was largely responsible for the recession in Italy in 2012 and 2013. They attribute this result to the fact that during this period the Italian fiscal *"adjustments were all TB [tax-based]"*. According to their estimates, *"had Italy chosen to mostly cut expenditures rather than raise taxes, its GDP growth would have been 2 percent higher in every single year [between 2011 and 2013], with a cumulative 'additional' 6 percentage points of growth"* (Alesina *et al*, 2015).

In Italy, the loss of output growth between 2011 and 2013 considerably widened the gap with Belgium in terms of GDP per capita. After increasing from 9 percent in 2007 to 15 percent in 2010, the gap further expanded to 23 percent in 2014 (Figure 7). Italy's recession in 2012 and 2013 had another drastic consequence. Its banking system's NPL ratio, which had reached 10 percent in 2010, rose to 16.5 percent in 2013, further impairing its ability to make fresh loans to the economy. Subsequently, the Italian NPL ratio peaked at 18.1 percent in 2015 and then gradually declined. By contrast, in Belgium the banking system managed to contain its NPL ratio below 5 percent throughout the crisis, thus preserving its ability to finance the growth of the real economy.

**Figure 7: GDP per capita in constant prices (PPP, 2011 international dollars), 1990-2017**



Source: Bruegel based on IMF WEO database.

The austerity measures increased Italy's debt-to-GDP ratio from 117 percent of GDP in 2011 to 129 percent in 2013. During the same period, by continuing to run a primary deficit and stimulating economic activity, Belgium managed to keep its debt-to-GDP ratio more or less constant during this period. As a result the debt-to-GDP differential between Italy and Belgium, which was 14 points of GDP in 2011, increased to 24 points in 2013. Austerity did not help the rating of Italian sovereign debt. On the contrary, it led to further downgrades in 2012, 2013 and 2014. In July 2012, Moody's cut Italy's rating by two more notches to Baa2, only two notches above non-investment grade. S&P lowered its rating by one notch in July 2013 and a further notch in December 2014 to BBB-, only one notch above non-investment grade. The contrast with Belgium, which has enjoyed a sovereign rating only two notches below triple-A for S&P and three for Moody's since December 2011 (with Fitch sharing S&P's rating until December 2016, when it aligned its rating with Moody's), is striking.

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## 6 Italy vs. Belgium: a thought experiment

Consider the following thought experiment. Suppose you were at the end of 2007, on the eve of the financial crisis, and you had carefully studied the economic and political evolution of Belgium and Italy during the previous 15 years. Should you have predicted that during the crisis the debt-to-GDP ratio would increase much more in Italy than in Belgium?

I suggest that the correct answer to this question is 'yes and no'.

There is little doubt that, back in 2007, the outlook for debt sustainability was less favourable for Italy than for Belgium. This was certainly the view of rating agencies. That year, Belgium enjoyed the second-highest rating possible from S&P, Moody's and Fitch, while Italy was rated one (by Moody's), two (by Fitch) or even three (by S&P) notches lower.

There were good reasons for such a view, which are all encapsulated in one basic fact: during the period starting immediately after Maastricht (in 1993 for Belgium and in 1994 for Italy) and ending in 2007, the debt-to-GDP ratio was reduced much more in Belgium than in Italy. Although lower productivity and GDP growth in Italy clearly played a role, the main reason for the lower debt reduction in Italy was its lower primary surplus.

The political capacity of Belgium and Italy – the two EU countries with the highest debt-to-GDP ratios at the time of Maastricht – to run sufficiently high primary surpluses over a sufficiently long period of time to (1) qualify for membership of the euro area in 1999, and (2) to continue lowering their debt ratios after joining the euro, was always regarded as a challenge because it implied a radical change to the previous behaviour that had resulted in high public debt accumulation.

Hallerberg (2000) studied the institutional reforms put in place by Belgium and Italy after Maastricht to help reduce their debt ratios sufficiently to join the euro. In Belgium, these reforms gave more teeth to the High Council of Finance, a body outside the government originally set up in 1936 and already revamped in 1989 to try and control the public debt. Similarly, in Italy, the government delegated significant powers to the finance minister after Maastricht in order to reign in the public budget. Although Hallerberg (2000) found these reforms were successful in lowering the debt ratios in the two countries in the run-up to the euro, he questioned whether they would be sufficiently robust to continue delivering further fiscal efforts after the countries qualified for euro membership. These worries turned out to be well justified. The institutional reforms put in place after Maastricht did lose some momentum after the two countries joined the euro, but they resisted better and delivered larger primary surpluses in Belgium than in Italy until 2007.

All this suggests that, on the eve of the crisis, Italy enjoyed a less favourable track record than Belgium in terms of public debt sustainability. Accordingly, one should have predicted that in case of a shock, the Italian debt would be more vulnerable to a change in market sen-

timement than Belgian debt. This is exactly what happened in 2011-13, after the Greek sovereign debt crisis spread to other euro-area countries, sending shockwaves through the Italian sovereign bond market but leaving the market for Belgian bonds relatively calm. What would have been difficult to predict, however, is the magnitude of the impact of the shock on the Italian sovereign bond market.

What happened in Italy between 2011 and 2013 seems to confirm the line of reasoning of De Grauwe and Ji (2012 and 2013) about panic-driven austerity and self-fulfilling crises in peripheral euro-area countries. Their main argument is that financial market sentiment about peripheral euro-area countries turned more negative in 2010 and 2011 than was justified by their economic fundamentals; that market sentiment led to panic-driven austerity measures by national governments, in turn worsening economic fundamentals, feeding into worsened market sentiment; and that only the ECB could have stopped this self-fulfilling crisis by reassuring markets that it was ready to inject sufficient liquidity into the sovereign bond market of peripheral countries.

Although De Grauwe and Ji (2012 and 2013) make a clear distinction between peripheral and core euro-area countries and argue that Italy (like Belgium) belonged to the group of core euro-area countries, their thesis seems to fit the Italian case perfectly. In 2011, one year into the euro-area sovereign debt crisis, markets suddenly demanded yields on Italian government bonds far in excess of yields on Belgian bonds. This led to austerity measures by the Italian government in 2011 and 2012 that produced negative growth in 2012 and 2013 and a sharp increase in the debt-to GDP ratio. The fact that Italian spreads reached an all-time high on 24 July 2012, two days before Mario Draghi's London speech promising to do *"whatever it takes"*, and declined sharply thereafter, lends support to the view of De Grauwe and Ji (2012 and 2013) that markets had succumbed to self-fulfilling prophecies of Italy leaving the euro and that the ECB was capable of guiding them back to calmer sentiment if and when it displayed sufficient determination.

Yet, neither the spread between Italian and Belgian government bonds (see Figure 5B) nor the sovereign rating differential between the two (Figure 5C) have returned to their pre-2011 levels. For a while, after the ECB's announcement during the summer of 2012 and especially after it launched its asset purchase programme in March 2015, buying massive amounts of government bonds from banks to support economic activity and inflation in euro-area countries, it seemed that the situation had calmed. But in November 2016, on the eve of the referendum that Italian prime minister Matteo Renzi lost the next month, and which led to his resignation, spreads between Italian and Belgian 10-year bonds again rose beyond 100 basis points. And in May 2018, during the political crisis that preceded the appointment of Giuseppe Conte as Italian prime minister, these spreads even reached 200 basis points for the first time since the period of 12 months that started in November 2011, when the Berlusconi government was forced to resign.

The timing of these three recent episodes – November 2011, November 2016 and May 2018 – suggests that domestic politics in Italy bears a heavy responsibility for sending markets into a panic about the country's creditworthiness. The fact that domestic politics played such an important role in these events also suggests that, though clearly useful, ECB intervention was not and could not have been sufficient to restore the confidence of markets in the Italian sovereign to its-pre crisis level. This required changes in domestic politics.

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## 7 Conclusions

I draw three conclusions from the comparison between Belgium and Italy during the period from 1990 to 2018.

First, compared to Belgium, a country that entered the euro in 1999 with an even higher debt-to-GDP ratio, Italy suffered from a number of economic weaknesses on the eve of the crisis in 2007 that made it more likely to be negatively affected by the crisis. The main responsibility for this state of affairs lies with Italian domestic politics. Italy was unable to introduce sufficient economic and social reforms to boost potential growth and to continue running sufficient primary budgetary surpluses after joining the euro. But Italy's failings also demonstrate that the governance of the euro area was too weak to prevent such a situation, which had consequences not only for Italy but for the entire euro area. It is precisely because economic and financial spillovers increased among the countries that joined the euro that economic and financial surveillance and the ability to take corrective action in case of problems should have been more wide-ranging and more stringent than the Stability and Growth Pact, the only European instrument available before the crisis. Unfortunately, it took the crisis to finally see the introduction of European mechanisms such as the Macroeconomic Imbalance Procedure (in 2011), the Fiscal Compact (in 2013) and the banking union (starting in 2014).

Second, in the wake of the sovereign debt crisis that started in Greece and then spread to other vulnerable euro-area countries, national governments and euro-area authorities focused too much on austerity measures, which often proved counter-productive by reducing GDP growth and increasing debt burdens. By adopting austerity measures in 2011-12 to try and counter the decreasing appetite of financial markets for its sovereign debt, Italy fell into this debt trap. Once again, the main responsibility for this situation lies with the Italian authorities, which needed to demonstrate to markets their seriousness about debt sustainability but which refused to enact growth-enhancing measures, hence leaving austerity as the only option. However, European partners and authorities also played a major role. Their demands for fiscal measures probably worsened the situation in Italy. On the other hand, when they became sufficiently forceful, ECB measures proved effective in reducing spreads. Nonetheless, the Italian situation shows it would be wrong to conclude that ECB measures alone can suppress the fears of markets that public debt might be unsustainable. The sustainability of public debt, when it is in doubt, requires the right action by national authorities. Typically, this will imply growth-enhancing measures rather than austerity. Lack of determination by the political authorities to maintain or reinforce the country's creditworthiness is bound to be severely punished by markets and render ineffective measures taken by the ECB, however forceful they might be.

Finally, it all comes down to politics. Bad domestic politics during the two decades prior to Maastricht was responsible for the huge accumulation of public debt in Belgium and Italy. After Maastricht, the prospect of joining the euro on the condition that they met the relevant criteria was a strong incentive for politicians in both countries to take the necessary steps to reduce significantly the public debt levels. However, once the two countries joined the euro the fiscal discipline of the new regime embedded in the Maastricht rules and in the Stability and Growth Pact proved too weak and allowed the debt paths of Belgium and Italy to diverge, with Belgium continuing to make significant efforts to reduce its debt, while Italy's efforts weakened. In Belgium, Maastricht and the euro were really used by politicians to constrain their fiscal behaviour, in the same way that they had used earlier the Exchange Rate Mechanism (ERM) of the European Monetary System (EMS) as disciplining devices. By contrast, in Italy the constraint imposed by Maastricht and the euro on politicians in their fiscal behaviour was weaker, mirroring the weaker disciplining effect of the EMS on this country and its exit from the ERM in 1992.

The different attitude of politicians in the two countries towards debt sustainability and ultimately towards the euro was most obvious during the crisis. In Belgium there was a unanimous consensus among politicians that the country's high debt level was a source of

fragility and that membership of the euro was economically and politically vital for the country's well-being. This absolute commitment to the euro allowed Belgium to largely escape the pressure of markets to take austerity measures at the height of the euro-area sovereign debt crisis. In Italy the situation was very different. The weaker commitment of domestic politicians to debt sustainability and even to the euro sent markets into a panic that forced the government to take austerity measures at the worst time. The lesson is that high public debts in the euro area require an absolute commitment from politicians to debt sustainability and to euro membership. Any deviation from this commitment will be immediately and severely punished by markets, with the ECB having limited ability to correct the situation.

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